(c) *Effective date.* The provisions of this section will apply with respect to obligations issued after October 9, 1969, and before final regulations are promulgated.

[T.D. 7072, 35 FR 17406, Nov. 13, 1970; 35 FR 18524, Dec. 5, 1970, as amended by T.D. 7174, 37 FR 10932, June 1, 1972; T.D. 7273, 38 FR 10927, May 3, 1973]

§§ 13.5–13.9 [Reserved]

§ 13.10 Distribution of money in lieu of fractional shares.

(a) *In general.* (1) Under the general rule of section 305, as amended by section 421(a) of the Tax Reform Act of 1969, gross income does not include the amount of any distribution of the stock (or rights to acquire the stock) of a corporation made by such corporation to its shareholders with respect to its stock. Under an exception to the general rule, a distribution by a corporation of its stock or rights to acquire its stock is treated as a distribution of property to which section 301 applies if the distribution (or a series of distributions of which such distribution is one) has the result of (i) the receipt of money or other property by some shareholders, and (ii) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. Also, the Secretary or his delegate is directed to prescribe regulations under which a redemption which is treated as a distribution to which section 301 applies, or any other transaction having a similar effect on the interest of any shareholder, shall be treated as a distribution with respect to any shareholder whose proportionate interest in the assets or earnings and profits of the corporation is increased by such redemption or transaction.

(2) The general rule, and not the exception, applies in the case where cash is distributed in lieu of fractional shares to which the shareholders would otherwise be entitled, provided the purpose in distributing the cash is to save the distributing corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares (or scrip representing fractional shares), or issuing full shares representing the sum of fractional shares, and not to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation.

(b) *Illustration.* The application of paragraph (a) of this section may be illustrated by the following example:

Example. Corporation X is a large corporation whose stock is widely held by the public, no one shareholder owning more than 10 percent of the outstanding stock. The stock is listed on a recognized exchange and is currently selling at less than $75 per share. During the year the corporation pays a 3-percent stock dividend. Cash is paid to each shareholder in lieu of a fractional share to which he would otherwise be entitled. The distribution of cash in lieu of fractional shares is not intended to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corporation, but is intended to save the corporation the trouble, expense, and inconvenience of issuing and transferring scrip representing fractional shares. The general rule, and not the exception, applies in this situation.

(Sec. 305(c), 83 Stat. 614; 26 U.S.C. 305(c))

[T.D. 7039, 35 FR 7012, May 2, 1970]

§ 13.11 Revocation of election to report income on the installment basis.

(a) *In general.* Under section 453(c)(4) taxpayers who are dealers in personal property and who elected installment-basis income reporting, subject to the provisions of section 453(c)(1) (relating to change from accrual to installment basis), may revoke their previously made election.

(b) *Time and manner of revoking election.* The revocation by a taxpayer may be made by filing an amended return on an appropriate form or forms, such as Form 1040X for an individual taxpayer, for the year of change (the first year for which income was computed using the installment basis) and for each subsequent year for which a return was filed using the installment basis. The taxpayer should indicate on such amended returns that he is revoking an election to report income on the installment basis. Such revocation must be made within 3 years from the last date prescribed for the filing of the return for the year of change including any extension of time granted the taxpayer. In reporting income on the amended returns described in this section, the taxpayer shall use the accrual method of accounting.

[T.D. 7044, 35 FR 8823, June 6, 1970]

PART 14a—TEMPORARY INCOME TAX REGULATIONS RELATING TO INCENTIVE STOCK OPTIONS

AUTHORITY: 26 U.S.C. 7805.

§ 14a.422A–1 Questions and answers relating to incentive stock option transitional rules.

The following questions and answers relate to the application of incentive stock option (ISO) treatment to certain previously granted stock options, pursuant to section 422A of the Internal Revenue Code of 1954, as added by section 251 of the Economic Recovery Tax Act of 1981 (95 Stat. 172) (ERTA):

GENERAL DESCRIPTION OF SECTION 422A AND ITS TRANSITIONAL RULES

Q–1: What is the significance of new section 422A of the Code entitled ''Incentive Stock Options?''

A–1: Prior to the enactment of section 422a, the tax treatment of employee stock options generally was governed by section 83 of the Code and the regulations thereunder. Under those rules, the value of a stock option constituted ordinary income to the employee when granted only if the option itself had a readily ascertainable fair market value at that time. If the option did not have a readily ascertainable value when granted, it did not constitute ordinary income at that time. Instead, when the option was exercised, the difference between the value of the stock at exercise and the option price constituted ordinary income to the employee. An employer who granted a stock option generally was allowed a business expense deduction equal to the amount includible in the employee's income in its corresponding taxable year. Section 422A provides for incentive stock options (ISO's). Under this new provision there will be no tax consequences when an ISO is either granted or exercised, and the employee generally will be taxed at capital gains rates when and if the stock received on exercise of the option is sold. Similarly, no business expense deduction will be allowed to the employer with respect to an ISO.

Q–2: What requirements must be met for ISO treatment under section 422A?

A–2: (a) Section 422A provides that the employee, in order to receive ISO treatment, must not dispose of the stock within two years after the option is granted, and must hold the stock itself for at least one year. If all requirements other than these holding period rules are met, tax is deferred until disposition of the stock, but gain (in an amount equal to the lesser of (1) the fair market value of the stock on the date of exercise minus the option price or (2) the amount realized on disposition minus the option price) is treated as ordinary income and the employer is allowed a deduction at that time.

(b) In addition, for the entire time from the date of granting the option until three months before the date of exercise (expanded to 12 months if employment ceased due to permanent and total disability), the option holder must be an employee either of the company granting the option, a parent or subsidiary of that corporation, or a corporation (or parent or subsidiary of that corporation) which has assumed the option of another corporation as a result of a corporate reorganization, liquidation, etc. This requirement and the holding period requirement are waived in the case of the death of the employee.

(c) For an option to qualify as an ISO, the following conditions must be met:

(1) The option must be granted under a plan specifying the aggregate number of shares of stock which may be issued and the employees or class of employees eligible to receive the options. This plan must be approved by the stockholders of the granting corporation within 12 months before or after the plan is adopted.

(2) The option must be granted within ten years from the date the plan is adopted or the date the plan is approved by the stockholders, whichever is earlier.

(3) The option must by its terms be exercisable only within ten years of the date it is granted.

(4) The option price must equal or exceed the fair market value of the stock at the time the option is granted. This requirement will be deemed satisfied if there has been a good faith attempt to value the stock accurately, even if the option price is less than the stock value.

(5) The option by its terms must be nontransferable other than at death and must be exercisable during the employee's lifetime only by the employee.

(6) The employee must not, at the time the option is granted, own stock representing more than ten percent of the voting power of all classes of stock of the employer corporation or its parent or subsidiary. However, the stock ownership limitation will not apply if the option price is at least 110 percent of the fair market value (at the time the option is granted) of the stock subject to the option and the option by its terms is not exercisable more than five years from the date it is granted.